No. 13,805

IN THE

United States Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THOMAS H. BRODHEAD and ELIZABETH S. BRODHEAD,
Respondents.

On Petition for Review of the Decisions of the Tax Court of the United States.

BRIEF FOR RESPONDENTS.

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OPINION BELOW.

The opinion of the Tax Court (R. 140-161) is reported at 18 TC 726.

JURISDICTION.

The petition for review in these cases involves deficiencies aggregating $169,553.49 in the federal income taxes of the taxpayer, Thomas H. Brodhead (herein called the "Taxpayer"), and his wife, Elizabeth S. Brodhead, for the years 1943, 1944, 1945 and 1948 (R. 5, 18, 163-169).

On February 7, 1950[1] the Commissioner of Internal Revenue (herein called the "Commissioner") mailed to the Taxpayer and his wife notices of deficiencies in their income taxes for the years in question (R. 11, 29). Within 150 days thereafter, on July 3, 1950 (R. 1, 4), the Taxpayer and his wife, pursuant to Section 272 of the Internal Revenue Code, filed petitions with the Tax Court for redetermination of such deficiencies. The proceedings were consolidated for hearing in the court below (R. 2, 4). On October 31, 1952, decisions of the Tax Court were entered redetermining the deficiencies (R. 162, 163). On January 19, 1953, the Commissioner filed his petition for review invoking the jurisdiction of this court under Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948 (R. 163-167).

QUESTIONS PRESENTED.

1. Whether on all of the evidence in the record the Tax Court's finding of fact, that Thomas H. Brodhead and the trustees of the Thomas H. Brod-

[1]There were added to the gross income of the Taxpayer and his wife for each of the years in question amounts in excess of 25 per cent of the amounts of gross income stated in their joint returns (R. 13, 33, 36, 38). See Section 275(c) of the Internal Revenue Code. On or about January 18, 1949, a consent was executed extending to June 30, 1950, the period within which an income tax might be assessed or a deficiency notice mailed to the Taxpayer for the year 1943 (R. 151-152).

head Trust and of the Elizabeth S. Brodhead Trust really and truly intended to, and did, join together for the purpose of carrying on the business of T. H. Brodhead Co. and sharing in its profits and losses, is so unreasonable as to require a reversal of the decision below.

2. Whether the Tax Court erred in holding that in the creation of the two trusts, the Taxpayer and his wife did not retain sufficient interest in or control over the corpus or income thereof to render the Taxpayer liable for income taxes on the income thereof.

STATUTES AND REGULATIONS INVOLVED.

The pertinent statutes and regulations are set forth in the Appendix, *infra.*

STATEMENT.

The Taxpayer does not controvert the Commissioner's statement of the case in the Brief for the Petitioner (herein cited "Brief") (pp. 3-13).

SUMMARY OF ARGUMENT.

The Commissioner does not deny that under the local law the Thomas H. Brodhead Trust and the Elizabeth S. Brodhead Trust were valid and binding trusts, and the special partnership was a valid and subsisting special partnership. The sole question presented is whether the special partnership should be recognized and given effect under the revenue laws of the United States. The test for determining that question has been formulated by the Supreme Court of the United States in *Commissioner v. Culbertson,* 337 U.S. 733, 93 L.ed 1659 (1949), and whether any given partnership measures up to that test is a question of fact. *Commissioner v. Culbertson, supra,* at 741-42. A finding of fact made by the Tax Court will not be disturbed on review unless it is clearly unreasonable. *Boehm v. Commissioner of Int. Rev.,* 326 U.S. 287, 293-94, 90 L.ed 78, 84-85 (1945); *Commissioner of Int. Rev. v. Scottish Am. Inv. Co.,* 323 U.S. 119, 123-24, 89 L.ed 113, 116-17 (1944); *Helvering v. Kehoe,* 309 U.S. 277, 279, 84 L.ed 751, 753 (1940). An examination of the record in the case at bar reveals not merely a substantial basis therein for the Tax Court's finding on this question, but clear and convincing evidence virtually compelling the conclusion at which the Tax Court arrived.

The income of a private express inter vivos trust, although not payable to the grantor thereof, may be taxed to him under the revenue laws of the United States if the grantor retains a sufficient "bundle of rights" in the trust, *Helvering v. Clifford,* 309 U.S. 331, 84 L.ed 788 (1940), as where a grantor creates a short term trust, names himself as trustee, grants himself broad discretion as to the income to be distributed and retains a reversionary interest in the corpus of the trust. In the case at bar, however, the

Taxpayer made an absolute irrevocable transfer in trust to independent trustees, for a substantial term, had no control over the income of the trust, and possessed no reversion in the corpus thereof. Under the special partnership agreement the Taxpayer had no control over the corpus or income of the trust which he could exercise for his own benefit. The case of *Helvering v. Clifford, supra,* is clearly inapplicable to the instant case.

The Commissioner in his argument (Brief 14-18) reads into the opinion of this court in *Toor v. Westover,* 200 F.2d 713 (1952), a departure from the test laid down by the Supreme Court in *Commissioner v. Culbertson, supra,* and seeks to establish a rule of law making the issue in family partnership cases one to be determined by the very kind of "objective test" so clearly repudiated by the Supreme Court in *Commissioner v. Culbertson.*

ARGUMENT.

I.

THE EVIDENCE APPEARING IN THE RECORD CLEARLY SUPPORTS THE TAX COURT'S FINDING OF FACT, THAT THE TAXPAYER AND THE TRUSTEES OF THE THOMAS H. BRODHEAD TRUST AND OF THE ELIZABETH S. BRODHEAD TRUST REALLY AND TRULY INTENDED TO, AND DID, JOIN TOGETHER FOR THE PURPOSE OF CARRYING ON THE BUSINESS OF THOMAS H. BRODHEAD CO. AND SHARING IN ITS PROFITS AND LOSSES.

The Commissioner does not deny that under the local law the Thomas H. Brodhead Trust and the Elizabeth S. Brodhead Trust were valid and binding trusts, and the special partnership was a valid and subsisting special partnership. The sole question presented is whether the special partnership should be recognized and given effect under the revenue laws of the United States. The test for determining that question has been formulated by the Supreme Court, in *Commissioner v. Culbertson, supra,* in the following language:

> ". . . whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. . . ." (337 U.S. 733 at 742-43)

> ". . . if the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. . . ." (*id.* at 747)

A review of the record reveals ample support in the evidence for the Tax Court's finding on the question as posed in the *Culbertson* case.

A. *The Agreement.* The terms of the special partnership agreement (R. 65-79) clearly reflect the intent of the parties to join as partners in the enterprise. The first (unnumbered) paragraph of the agreement (R. 65-66) recites that the parties "do hereby form with each other a special partnership for the purpose of acquiring and thereafter conducting the business heretofore carried on by Thomas Holmes Brodhead . . . and for other purposes . . . .", which other purposes are spelled out in detail in paragraph 1 of the agreement (R. 66-67).

Paragraph 3 of the agreement (R. 68) sets forth the respective capital contributions of the partners and secures to the special partner all of the powers, rights and duties of special partners as prescribed by Chapter 225 of the Revised Laws of Hawaii 1935 (See Appendix, *infra*) as the same might from time to time be amended. The same paragraph provides that the special partner shall not be liable for the debts of the partnership beyond the limits set by Section 6887 of the Revised Laws of Hawaii 1935 (See Appendix, *infra*), as the same might from time to time be amended.

Paragraph 4 of the agreement provides for compensation for services rendered to the partnership by the general partner, in such amount as the partners, including the special partner, might agree upon, and provides that such compensation shall be chargeable as an expense of the business for the purposes of computing the net profits of the partnership (R.

68-69). The same paragraph provides for annual division of the net profits of the partnership in proportion to the respective capital interests of the partners, and permits either partner to withdraw such portion of his share of profits as both partners may from time to time deem advisable (R. 69).

Paragraph 7 of the agreement expressly recognizes the right of the special partner to investigate the partnership affairs and to advise the general partner as to its management at all times (R. 70).

Paragraph 9 of the agreement requires that proper partnership books of account be kept, and expressly confers upon each of the partners the right at all times to have full and free access to, and to make copies of, the partnership books (R. 71).

Paragraph 10 of the agreement requires annual general accounts to be taken of all of the assets and liabilities and dealings and transactions of the partnership, and expressly requires that copies of such accounts be sent to each partner (R. 71).

Although pursuant to paragraph 8 of the agreement the general partner could not assign or mortgage his share of or interest in the partnership or its assets or profits at any time, the special partner was free to assign its interest in the partnership with the consent of the general partner (R. 71).

Paragraph 11 of the agreement provides that upon the determination of the partnership from whatever cause, the assets of the partnership remaining after payment of its debts and expenses shall be applied first to the payment of the amounts standing to the partners' credit in their advance accounts, and then to repayment of their capital contributions, according the special partner priority in distribution in each case (R. 72-73).

B. *The Conduct of the Parties.* The evidence in the record concerning the conduct of the parties in pursuance of the partnership agreement clearly reflects that they intended to, and did, join together for the purpose of carrying on the enterprise and sharing in its profits and losses.

The taxpayer rendered services to the partnership as its manager, in accordance with paragraph 5 of the agreement (R. 182, 219). For those services he was paid reasonable compensation, which was deducted as an expense of the partnership business in computing the profits thereof (R. 182-83).

The special partner investigated the partnership affairs and advised the Taxpayer, as general partner, as to its management in accordance with the partnership agreement and with the applicable law. In this connection the evidence shows that the Taxpayer consulted very frequently with the special partner, every day or every couple of days; furnished it all financial statements; and took up and discussed with the special partner such matters as financing, the need for added capital, and the taking on of new lines (R. 185-86, 219, 229-31, 234-35).

The testimony of the trust officer who succeeded to the responsibility for the trusts' accounts shows that the special partner consulted and advised with the Taxpayer as to how business was going, the need of retaining capital in the business due to its continuous growth, taking on new lines, and the amount of the Taxpayer's salary as general manager (R. 229-31, 234-35). Audit reports, and oral reports on operations, were furnished to the special partner regularly (R. 185, 230).

With the exception of certain periods when, with the consent of the special partner, certain partnership profits were retained in the business to permit the accumulation of additional capital, the special partner insisted upon, and received, its full distributive share of the partnership income (R. 131, 133, 134, 200-01, 234-35).

When the Elizabeth S. Brodhead Trust purchased the interest of the Thomas H. Brodhead Trust in the special partnership, the Thomas H. Brodhead Trust received the full fair value of its interest as the purchase price (R. 193), and when the assets of the partnership were sold, the consideration paid therefor was divided between the Taxpayer and the special partner in strict accordance with their respective interests in the partnership enterprise (R. 160-84).

The parties to the special partnership agreement, including the trusts, held themselves out to the public as general and special partners respectively, by filing in the office of the Treasurer of the Territory of Hawaii a duly executed certificate of special partnership, by publishing a statement of substance of certificate of special partnership in the Honolulu Advertiser on four different days (R. 46, 85-92), by subsequently filing an appropriate certificate of change of special partnership and publishing a statement of substance thereof in the Honolulu Advertiser on four different days (R. 47-48, 108-15), and thereafter by filing a further certificate of change of special partnership and publishing a statement of substance thereof in the Honolulu Advertiser on four different days (R. 48-49, 119-21).

C. *The Relationship of the Parties.* The evidence in the record with respect to the relationship of the parties lends ample support to the Tax Court's finding. Mortimer J. Glueck, co-trustee with Bishop Trust Company, Limited, of each of the trusts, had known the Taxpayer for many years and had grown up with Taxpayer's business as an advisor to the Taxpayer (R. 173-74, 176-77, 186-88, 216-17). There is no indication in the record that Mr. Glueck was in any way subservient to the Taxpayer in matters of business judgment. If anything, he appears to have been the dominant, independent party to their association (R. 174, 218-25).

Bishop Trust Company, Limited, had no prior relationship to the taxpayer, except that it was named executor in his will (R. 202), and it maintained at all times a relationship of independent arm's-length dealing with him. The trust company exercised its independent judgment in deciding whether to become co-trustee and special partner (R. 221-22). Mr. Glueck and the trust company, as special partner, insisted upon full withdrawal of its share of the partnership earnings (R. 187, 191, 208, 249, 256-57), and exercised independent judgment on partnership affairs, including the sale of the partnership interest (R. 185, 199-200, 207-08, 215, 219-21, 231-32, 233, 238). In the matter of trust investments it exercised wholly independent judgment, even flatly refusing to make an investment suggested by the Taxpayer (R. 202-03).

D. *Abilities and Contributions of the Parties.* An examination of the evidence in the record relating to the respective abilities and contributions of the parties indicates ample support for the finding made by the Tax Court.

The Taxpayer had been in business since 1935, but in the years immediately preceding the formation of the special partnership the business had grown so large that he no longer felt capable of administering it alone (R. 172-75, 188-89, 216-18). He contributed both capital (R. 68) and services (R. 182, 219) to the enterprise.

Mortimer J. Glueck, co-trustee with Bishop Trust Company, Limited, of each of the trusts, had grown up with Taxpayer's business, and had long advised the Taxpayer in matters of business management. He was the successful proprietor of a business of his own. (R. 173-74, 176-77, 186-88, 216-17.)

Bishop Trust Company, Limited, conducted a trust company business in the Territory of Hawaii and had enjoyed wide experience in operating business enterprises in a fiduciary capacity. Among the various businesses operated by the trust company were included a structural steel company, a department store, a tile business, dairies, ranches, an ice cream business, a soda and ice works which held the Coca-Cola franchise for one of the Hawaiian Islands, and an auto sales agency (R. 226-29). Mr. Glueck and the trust company, as special partner, contributed capital to the enterprise (R. 90) and contributed advice and consultation to the full extent permitted by law (R. 185-86, 219, 229-31, 234-35).

Capital was an important income-producing factor in the partnership business. The business volume had increased tremendously as a result of the outbreak of World War II and the demands of the Armed Forces (R. 188-89), and throughout the existence of the special partnership, the special partner was concerned with the need for additional capital in connection with the expansion of the business (R. 230, 234).

E. *Actual Control of Income.* The evidence of record with respect to the exercise of actual control over the special partnership income fully supports the Tax Court's finding. The determination as to the time and amount of distributions of partnership earnings was required to be made by both partners jointly (R. 69) and the special partner firmly insisted upon withdrawing the entire amount of its distributive share of the special partnership net profits (R. 201, 131, 133, 134). The special partner received and held under its exclusive dominion and control its entire distributive share of partnership income and none thereof was ever paid to the Taxypayer or used in discharge of his obligation to support his wife and children (R. 183).

F. *Business Purpose.* The evidence clearly reveals a proper business purpose for the formation of the partnership. The business represented the Taxpayer's entire worldly fortune, and it had grown to the point where he no longer felt able to carry it on by himself. Moreover, he was concerned over the possibility that his life expectancy was considerably shorter than normal. He desired to assure the continuity of the business irrespective of his early demise and to assure the availability of experienced management advisors. (R. 174-77, 188, 217-18.)

The purpose of preserving and continuing a going business as a family enterprise for the members of a family is a proper, legitimate, and indeed a commendable, business purpose. *Ardolina v. Commissioner of Internal Revenue,* 186 F. 2d 176 (3d Cir. 1951); *Nicholas v. Davis,* 204 F. 2d 200 (10th Cir. 1953).

There is no evidence in the record indicating any motive of tax avoidance or desire to reallocate income within the family group.

G. *Dominion and Control of Special Partner's Interest.* The Thomas H. Brodhead Trust was the donee of $40,000 (R. 52-53) and the owner thereof by virtue of a completed gift, as is more fully demonstrated under Point II, infra, which discussion is herein incorporated. And the Thomas H. Brodhead Trust invested the property given to it in the special partnership (R. 65-84). The Elizabeth S. Brodhead Trust was the donee of $10,000 (R. 92-107) and the owner thereof by virtue of a completed gift, as is also more fully demonstrated under Point II, infra, which discussion is herein incorporated. The Elizabeth S. Brodhead Trust purchased from the Thomas H. Brodhead Trust all of the latter's interest in the special partnership, thus in effect investing the property given to it in that partnership. To the extent that the differences between the two trusts are irrelevant here, the following discussion treats them as a single trust.

The Trust, as donee of the property which it had invested in the special partnership as a special partner, was clothed with all of the dominion and control permissible in a special partner under the law of the Territory of Hawaii (R. 68) and by its exercise of such dominion and control, it influenced the conduct of the partnership to the full extent that a special partner lawfully could do so (R. 185-86, 219, 229-31, 234-35). It had joint control over the disposition of special partnership income, and insisted upon full payment of all of the distributive share of special partnership income allocable to it under the terms of the special partnership agreement (R. 131, 133, 134, 200-01, 234-35). The record clearly indicates that the special partner enjoyed the "fruits of the partnership" to the very fullest.

From the foregoing review of the evidence appearing of record in the case at bar, it is obvious that there is more than sufficient support for the Tax Court's finding of fact that the Taxpayer and the trustees of the Thomas H. Brodhead Trust and of the Elizabeth S. Brodhead Trust really and truly intended to and did join together for the purpose of carrying on the business of T. H. Brodhead Co., and sharing in its profits and losses.

II.

THE INCOME OF THE TRUSTS IS NOT TAXABLE TO THE TAXPAYER UNDER THE DOCTRINE OF HELVERING v. CLIFFORD OR THE COMMISSIONER'S REGULATIONS RELATING THERETO.

In *Helvering v. Clifford, supra,* settlor created a trust for a term of five years (with the proviso that it would terminate earlier on the death of either settlor or his wife) with himself as trustee and his wife as income beneficiary. On the termination of the trust the entire corpus was to revert to the settlor, while accrued or undistributed net income and net proceeds from the investment of any such net income was to be treated as his wife's absolute property. During the continuance of the trust, settlor was to pay over such part of the income therefrom as he in his absolute discretion might determine, and during that period he had full power to exercise all voting rights incident to the trusteed shares of stock, to sell, encumber or otherwise dispose of any part of the corpus or income on such terms as he in his absolute discretion deemed fitting, and to invest any of the property of the trust by loans, secured or unsecured, by deposits in banks, or otherwise, without restriction as to the speculative character or rate of return of any such investment, or of any laws pertaining to the investment of trust funds. The Supreme Court, holding the settlor taxable on the income of the trust, in addition to the family relationship of the settlor and the beneficiary, emphasized the following factors: The short term of the trust, the fact that settlor was also the trustee, the absolute discretion in the settlor-trustee as to income to be distributed, and the reversion to the settlor upon the termination of the trust.

Underlying the decision of the Supreme Court in the *Clifford* case is the principle that where a purported donor retains controls over the subject matter of his gift, exercisable for his own personal benefit, sufficient to afford him the economic use and benefit of the property to substantially the same extent as if he were the absolute owner thereof, then the donor should remain taxable upon the income of that property.

An examination of the trust deeds in the case at bar shows that with the exception of the close family relationship between the Taxpayer and the beneficiaries, none of the factors considered in the *Clifford* case is present here.

The Thomas H. Brodhead Trust was to terminate twenty years after the death of the Taxpayer or sooner upon the death of the last survivor of the Taxpayer's children if at that time no lawful issue of such children were alive (R. 55-56). The Trustees, but not the Taxpayer, had power to terminate the trust at any time not more than one year after the trust might cease to be a member of the special partnership.

The Elizabeth S. Brodhead Trust was to continue until the youngest child of Elizabeth S. Brodhead, the Taxpayer's wife, attained the age of thirty-three years or would have attained that age had he or she survived. At the time of the creation of the trust, Elizabeth S. Brodhead had two children, the youngest of whom was less than one year old. Thus, the minimum term of this trust was thirty-two years (R. 94-95). The trustees, but not the Taxpayer or his wife, had power to terminate the trust at any time not more than one year after the trust might cease to be a member of the special partnership.

The Taxpayer did not name himself a trustee of the Thomas H. Brodhead Trust. Instead he carefully selected Mortimer J. Glueck and Bishop Trust Company, Limited, as trustees, in order to take advantage of their experience and knowledge (R. 174-75, 176-77). Moreover, he named one Edouard R. L. Doty as successor to Mr. Glueck, and provided that if Mr. Doty should be or become unable to act or decline to act or resign and after the death of Mr. Doty prior to the termination of the trust, the trust company might select some person as co-trustee in the place and stead of Mr. Doty (R. 62).

For similar reasons, and without any direction on the part of the Taxpayer, Elizabeth S. Brodhead selected Mr. Glueck and Bishop Trust Company, Limited, as trustees of the Elizabeth S. Brodhead Trust and made similar provisions with respect to successor trustees (R. 101, 205-07).

Any suggestion that by reason of his business and social association with the Taxpayer Mr. Glueck as co-trustee would be or was under the domination of the Taxpayer loses its force by reason of the fact that under the trust deed and the applicable law, the concurrence of both trustees would be required on all decisions. 2 *Scott, Trusts,* Sec. 194 (1939).

Since the Taxpayer was not a trustee of either of the trusts, it is self-evident that he could not under the trust deeds control the distribution or other disposition of the income therefrom.

The Taxpayer had no reversionary or remainder interest in either of the trusts. Upon the termination of the Thomas H. Brodhead Trust, the trust property was payable to the Taxpayer's living children and the lawful issue of his children who had died or, if there were no children or issue then living, to the heirs at law (other than the Taxpayer) of the last survivor of his children. If the trust were terminated by the trustee as a result of its withdrawal from the special partnership, the trust property was payable to the then living children of the Taxpayer and the lawful issue of such of them as were dead.

Upon the termination of the Elizabeth S. Brodhead Trust (whether by expiration of its term or by action of the trustees), the trust property was payable to the living children of Elizabeth S. Brodhead and the lawful issue of such of them as were then dead, or if there were no living children or issue, to the heirs at law (other than Elizabeth S. Brodhead and the Taxpayer) of the last survivor of the children of Elizabeth S. Brodhead.

Thus it is evident that none of the factors emphasized by the Supreme Court in the *Clifford* case and repeatedly re-emphasized by the lower courts is present in this case.

Treasury Regulations 111, Section 29.22(a)-21[2] (herein called the "Clifford Regulations"), embody the Commissioner's exegesis upon the doctrine of *Helvering v. Clifford, supra,* and is applicable only to taxable years beginning on and after January 1, 1946. The Commissioner, in his argument (Brief 18, n.7) suggests in passing that the 1946 income of the trusts might be taxable to the Taxpayer under either or both of Sections 29.22(a)-21(e)(2) and 29.22(a)-21(e)(4). Section 29.22(a)-21(e)(2) asserts the Commissioner's opinion that income of a trust, whatever

[2]TD 5488, 1946-1, Cum. Bull. 19;
TD 5567, 1947-2, Cum. Bull. 9.

its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant upon its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust through a power exercisable by the grantor or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, which enables the grantor to borrow the corpus or income directly or indirectly without adequate interest in any case or without adequate security except where a trustee (other than the grantor or spouse living with the grantor) is authorized under a general lending power to make loans without security to the grantor and other persons and corporations upon the same terms and conditions. Section 29.22(a)-21(e)(4) states the Commissioner's similar opinion with respect to a power, exercisable by the grantor in a non-fiduciary capacity, to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments.

The Commissioner suggests here that the terms of the trusts permitting the trustees to make loans to the partnership without liability for any resulting losses and providing that during the life of the Taxpayer the trustees shall obtain the consent of the settlor to the making of investments other than investments which trustees are permitted by law to make (R. 57, 96-97), render the 1946 income of the trusts taxable to the Taxpayer by the force of the Clifford Regulations. The Commissioner's error in this respect arises largely from the fact that, assuming as his major premise the result for which he contends, namely, that the special partnership was a mere sham not entitled to recognition for income tax purposes, the Commissioner reasons that the Taxpayer and the partnership were one and the same entity for all purposes.

Without conceding the validity of the Clifford Regulations, the Taxpayer contends that those regulations are inapplicable in the case at bar. The trustees' power to make loans to the special partnership is a far different thing from a power to make loans to the Taxpayer. Any such loan would be to the partnership and for the partnership's account and not to the Taxpayer personally or for his personal benefit. As a partner in the special partnership, the Taxpayer stood in a fiduciary relation to each of the other partners, including the special partner. The Supreme Court of the Territory of Hawaii has recently reaffirmed in the strongest terms the proposition that there is scarcely any relation in life which calls for more absolute good faith than the relationship of partners, and that the obligation is even greater in the case of a managing partner. *Watumull v. Ettinger,* Sup. Ct., T.H., (Jan. 3, 1952); see also *Toor v. Westover,* 200 F.2d 713, 715 (9th Cir. 1952).

Assuming that a loan had been made from the trust to the partnership (and the record reveals no such loan), the Taxpayer could only have diverted the proceeds of the loan to his personal use and benefit by a violation of his clear and unambiguous duty as a partner, which violation would give rise to a cause of action in favor of the trust against the Taxpayer. *Watumull v. Ettinger, supra.* The proposition that the naked power to seize property in violation of law renders the holder of that power taxable on the income of that property has never been seriously advanced.

In his argument from the requirement of consent to non-legal investments, the Commissioner overlooks the fact that the very terms of the Clifford Regulations restrict their applicability to a power exercisable *in a non-fiduciary capacity.* Under the doctrine of the *Clifford* case, a mere power to direct or veto proposed investments not exercisable for the benefit of the grantor does not render the holder of the power taxable on the income of the trust property. *Cushman v. Commissioner of Internal Revenue,* 153 F.2d 510 (2d Cir. 1946); *Kohnstamm v. Pedrick,* 153 F. 2d 506 (2d Cir. 1945).

In *Cushman v. Commissioner of Internal Revenue, supra,* petitioner created an irrevocable trust for the benefit of his children, naming himself and his wife as co-trustees with a corporate successor trustee. The petitioner reserved to himself, as grantor, the power to control retention or sale of trust property and to direct investment or reinvestment of trust funds. The Commissioner determined that the trust income was taxable to the petitioner under the doctrine of *Helvering v. Clifford,* supra, and the Tax Court agreed. On appeal to the Circuit Court for the

Second Circuit, the decision of the Tax Court was reversed. In answer to the Commissioner's contention the court held that petitioner's reserved power to control retention or sale of trust property and to direct investment and reinvestment of trust funds did not suffice to bring the case within the doctrine of *Helvering v. Clifford,* since the powers so retained could not be used contrary to the best interests of the beneficiary of the trust. Judge Chase, writing for the court, pointed out that ordinarily such powers are held in a fiduciary capacity and their exercise is subject to the scrutiny of the courts.

Again, in *Kohnstamm v. Pedrick, supra,* an appeal from a judgment dismissing the complaint entered after trial upon stipulated facts in the District Court for the Southern District of New York, plaintiff had created a trust for the benefit of his wife and children and had reserved to himself, as grantor, the power, among others, to direct the sale of any part of the trust fund and substitute equivalent investment and to vote all shares of stock held by the trust. Judge Learned Hand, writing for the court, in reversing the decision below, held that the power to direct the sale of trust assets and substitute equivalent investments, even when coupled with the other powers reserved, did not bring the plaintiff within *Helvering v. Clifford* and make him the owner of the trust property for tax purposes. See also *William P. Anderson,* 8 TC 921 (1947), Acq. 1947-2 Cum. Bull. 1; *Arthur L. Blakeslee,* 7 TC 1171 (1946), Acq. 1947-1 Cum. Bull. 1; *David L. Loew,* 7 TC 363 (1946);

Ernst Huber, 6 TC 219 (1946), Acq. 1946-1 Cum. Bull. 3.

The very terms of the trust deed in the case at bar (R. 57) negative any inference that the power reserved by the Taxpayer to require his consent to the making of certain investments during his lifetime is reserved for the benefit of anyone other than the beneficiary of the trust. The trust deed confers upon the trustees power to invest in property, real or personal, insofar as in their judgment they shall deem such investments advisable, and recites that in making such investments, the trustees shall not be restricted to investments which are legal for trust funds. The proviso reserving the power to require the Taxpayer's consent follows immediately after this grant and clearly relates to the making of investments which are not legal for trust funds. In every instance during the life of the Taxpayer, proposed investments must be investments which, in the judgment of the trustees, are advisable for the trust—that is, investments which are in the best interests of the income beneficiary and remainderman under the trust.

Thus, even if the Clifford Regulations are valid and applicable, the Taxpayer is not taxable upon the trust income by the force of those regulations.

If the Clifford Regulations are applicable, a determination that the 1946 income of the trust is taxable to the Taxpayer by the force of the regulations must result in the conclusion that the regulations as applied are invalid. As has been demonstrated above, the Taxpayer is not taxable upon the income of the trust under the doctrine of *Helvering v. Clifford* alone. If the Taxpayer is held taxable on the 1946 income of the trust without any change in the facts or in the applicable law, then the regulations are invalid for the reasons stated in *Commissioner of Internal Revenue v. Clark,* 202 F.2d 94 (7th Cir. 1953). In that case the taxpayers created irrevocable trusts for the term of five years subject to extension by the grantors. Thereafter and for good cause, the grantors extended the irrevocable term of the trusts for at least five additional years, all other provisions remaining unchanged. The Commissioner assessed the 1946 income of the trusts to the grantors on the theory that the terms of the trusts were of less than ten years' duration and hence the income thereof was taxable to the grantors under the Clifford Regulations. The Tax Court held that the 1946 income of the trusts was not taxable to the grantors under Section 22(a) of the Internal Revenue Code or under *Helvering v. Clifford, supra,* or under the Clifford Regulations. On appeal by the Commissioner, the Court of Appeals for the Seventh Circuit, affirming the decision of the Tax Court, held that the Clifford Regulations as applied in that case were unreasonable and arbitrary and therefore void. Chief Judge Major for the court pointed out that the regulations created a conclusive or irrebuttable presumption and thus stated a rule of substantive law. Hence, without any alteration in the trust indentures and without any change in the relation of any of the parties thereto that which was not income taxable to the grantors in 1944 and 1945 became income taxable to the grantors in 1946 solely as a result of the promulgation of the Clifford Regulations. Referring to cases in which the Supreme Court struck down as violative of due process a state statute which provided, in effect, that gifts of a decedent's estate made within six years of his death were made in contemplation thereof[3] and a congressional enactment which created a conclusive presumption that gifts made within two years prior to the death of the donor were made in contemplation of death,[4] Chief Judge Major stated that it appears that even Congress would be without power to create the conclusive presumption which the Treasury had attempted to create in the Clifford Regulations, and that it was even more certain that an administrative agency is without authority to promulgate such a regulation.

Exactly the same situation would exist in the case at bar if the trust income were taxed to the Taxpayer by the force of the Clifford Regulations. There was no significant change in the provisions of the trust deed between the years preceding and the year 1946. The Clifford Regulations create a conclusive or irrebuttable presumption, a rule of substantive law, effective January 1, 1946, that the existence of a power in the grantor to borrow corpus or income or of a power in a non-fiduciary capacity to veto proposed invest-

[3]*Schlesinger v. State of Wisconsin,* 270 U.S. 230, 70 L.ed 557 (1926).

[4]*Heiner v. Donnan,* 285 U.S. 312, 76 L.ed 772 (1932).

ments makes the income of a trust the income of the grantor thereof. For the reasons set forth in *Commissioner of Internal Revenue v. Clark, supra,* any such application of the Clifford Regulations to the case at bar would be arbitrary, unreasonable and void.

Thus, the terms of the trust and the circumstances of its creation demonstrate that the income thereof is not taxable to the Taxpayer under the doctrine of *Helvering v. Clifford* or the extension of that doctrine embodied in the Clifford Regulations.

A consideration of the terms of the trust and the circumstances of its creation, taken together with the terms of the special partnership agreement and the operations of the special partnership leads to a like conclusion. The term of the special partnership agreement was initially for the ten years from October 1, 1942, to September 30, 1952, and thereafter from year to year until terminated by either partner (R. 76-77). The term of the special partnership agreement, however, had no effect upon the term of the trust, and on termination of the partnership agreement, the Taxpayer could not receive any part of the special partner's share of capital or earnings. Indeed, the special partner was granted priority in distribution on termination (R. 71-73).

The Taxpayer was the general partner in the special partnership, but, as pointed out above (pp. 22-23), his powers as such were not and could not lawfully be exercised for his own personal benefit. Under the rule laid down by the Supreme Court of the Territory of Hawaii in *Watumull v. Ettinger, supra,* the Taxpayer owed a duty of absolute good faith to the special partner. See also *Toor v. Westover, supra.* Nor could the Taxpayer, as general partner, cause the assets of the special partnership to be diverted to any personal business of the Taxpayer. True, the special partnership agreement permitted the partnership to enter into a broad field of activity, but any business carried on by the partnership would be for the benefit and account of the partnership and of both of the partners therein.

Under the special partnership agreement, the Taxpayer had no power over the income of the partnership exercisable for his own benefit. The amount of the Taxpayer's compensation for services rendered to the partnership was to be determined by both of the partners, and by the very terms of the agreement was limited to the reasonable value of the services rendered (R. 69). Had the Taxpayer attempted to cause himself to be paid a salary in excess of that agreed upon with the special partner or an unreasonable salary (and there is no evidence in the record of any such attempt), he would have violated both the terms of the agreement and his duty of absolute good faith to his special partner, and would have been held to account under the rule of *Watumull v. Ettinger, supra.*

Similarly, partners' withdrawals from the partnership of the profits attributable to their interests was subject to the joint control of the Taxpayer and the special partner (R. 69). Any retention of partnership earnings could be accomplished only with the consent of the special partner, and would inure to the benefit of the partnership and both of the partners therein. Any attempt on the part of the Taxpayer (and the record indicates no such attempt) to withhold the earnings of the special partner would constitute a violation of the rule of *Watumull v. Ettinger, supra,* and render the Taxpayer accountable therefor.

Nor could the Taxpayer obtain control of the corpus of the trust for his own use or benefit. The Taxpayer, as the general partner, could terminate the special partnership at any time upon certain written notice (R. 72). In the event of such termination, however, the assets of the special partnership, after payment of its debts and expenses, were to be distributed to the partners and the special partner was afforded priority in this distribution (R. 72-73). The Taxpayer, as general partner, could use the assets of the partnership in the partnership business and share in the profits and losses thereof, but he could not, without violating his duty of absolute good faith to his partner, divert those assets to his own personal business or to any other business. *Watumull v. Ettinger, supra.* Similarly, the option granted to the Taxpayer's representative to succeed to or carry on the interest of the Taxpayer in the business in the event of the Taxpayer's death, would afford to the Taxpayer's estate no power to divert the partnership assets to the benefit of the estate, and all of the acts of the Taxpayer's representative upon succession to the Taxpayer's interest in the partnership would be governed by the same duty of absolute good faith which governed the Taxpayer during his lifetime.

Thus it is clear that under the doctrine of the *Clifford* case, the trust deed and special partnership agreement taken together with the circumstances surrounding the same did not reserve to the Taxpayer any power sufficient to render him taxable upon the income of the trust or the special partner's distributive share of the partnership income.

It is clear from the Commissioner's argument (Brief, 14-18) that he asserts the income in question to be taxable to the Taxpayer solely under the doctrine of *Helvering v. Clifford, supra,* and relies almost exclusively upon the language of the opinion of this Court in *Toor v. Westover, supra.* The Commissioner's only challenge to the *bona fides* of the special partnership is based on his assertion that the trustees did not become the real owners of the trust property (Brief, 18-19), and if this contention fails, his entire argument falls.

The Commissioner maintains that the trustees ". . . did not acquire the usual attributes of ownership with respect to the trust property" (Brief, 17) and lists nine propositions in support of this contention. That these nine propositions, to the limited extent that they have a basis in the law or the record, do not lead to the conclusion contended for, appears from the following *seriatim* examination thereof:

1. ". . . They were required to invest it in the partnership. . . ." (Brief, 17). The Commissioner's position here appears to be that a transfer of property in trust wherein the trustee is not granted the power of sale but is directed to retain the property so transferred cannot so shift the ownership of the property as to render the trustee or the trust beneficiaries taxable upon the income thereof. On this theory a transfer or gift of a partnership interest would never be effective to shift the incidence of taxation, since the donee would have no choice but to become a partner or refuse the gift. Simply to assert these propositions is to accomplish their refutation.

2. ". . . as a limited partner, they had no voice in the use of their investment . . . ." (Brief, 17). This statement simply is not borne out by the law, the special partnership agreement or the record. As pointed out above, the trustees were granted all of the voice in the use of their investment that it was possible to grant to a special partner under the law of the Territory of Hawaii and exercised their rights to the fullest. There is no doubt that a special or limited partner may be recognized under the revenue laws of the United States as a bona fide partner in a special or limited partnership. *Nicholas v. Davis,* 204 F. 2d 200 (10th Cir. 1953); *John A. Morris,* 13 TC 1020 (1949), Acq. 1950-1 Cum. Bull. 3; *Walter*

R. Stutz, 10 TCM 506 (1951); *William Collins, Sr.,* 7 TCM 830 (1948); *Jacques Spira,* 7 TCM 371 (1948).

3. ". . . they were not free either to withdraw or transfer their interest . . . ." (Brief, 17). This statement is not altogether free from its misleading elements, inasmuch as the special partner was not *absolutely* free to withdraw or transfer its interest, but was free to make such withdrawal or transfer with the consent of the general partner (R. 71). It may be noted that the general partner was not free to assign or mortgage his interest under any circumstances *(ibid.).* The Commissioner apparently concedes that restriction on the transferability of a partner's interest is not fatal to the existence of a bona fide partnership, for he cites with approval (Brief, 15) *Toor v. Westover, supra.* See also *Joseph Middlebrook, Jr.,* 13 TC 385 (1949), Acq. 1950-1 Cum. Bull. 3; *William Collins, Sr., supra.* Nothing in the language of the Supreme Court in *Helvering v. Clifford* would indicate that the donor of all or a part of a special partner's interest in a special partnership ipso facto retains powers over the subject matter of the gift sufficient to make him taxable upon the income thereof. Indeed, in *Nicholas v. Davis, supra,* the capital invested by the limited partners was given them by the general partners with the express understanding that such capital would be invested in the limited partnership; yet, the Court of Appeals for the Tenth Circuit held the partnership to be bona fide for tax purposes.

4. ". . . The taxpayer-settlor, on the other hand, retained complete control over the trust property which he had purportedly given away. . . ." (Brief, 17). Here again, the Commissioner confuses the Taxpayer and the special partnership. Far from retaining complete control over the trust property, the Taxpayer divested himself of all interest therein and of all control thereof excepting only such control as he could lawfully exercise in discharge of his duty of absolute good faith to his partner. *Watumull v. Ettinger, supra.* As has been pointed out, retained powers of control over trust property, if they are to render the income therefrom taxable to the donor, must be exercisable by the donor in a non-fiduciary capacity.

5. ". . . He [the Taxpayer] was assured that it would immediately be returned for use in the business which he controlled. . . ." (Brief, 17). Assurance that the trust corpus would be invested in a given business appears to be irrelevant under the Clifford doctrine unless that business is, in fact, controlled by the Taxpayer. And as has been so often repeated, the business was controlled by the Taxpayer only in his capacity as a fiduciary under a duty of absolute good faith to his fellow partner. Indeed, if this and the preceding proposition support the Commissioner's contention, then no transfer in trust wherein the donor named himself trustee could ever be sufficient to shift the incidence of taxation on the income of the transferred property, for in every such case the

donor, as donee-trustee, would retain full control of the property (subject, of course, to the terms of the trust instrument) in his fiduciary capacity as trustee.

6. ". . . The partnership which he [the Taxpayer] dominated could also use it in any other business. . . . " (Brief, 17). As has already been demonstrated, this statement is not in accord that the facts. The partnership was not "dominated" by the Taxpayer except as the general partner therein and, as such, the Taxpayer was bound to discharge a duty of absolute good faith to his fellow partner. Moreover, the partnership could not use the trust property "in any other business" except to the extent that the partnership engaged in another business. And if the partnership engaged in another business, it could do so only on behalf of and for the account of the respective partners, each of whom would share in the fruits of the enterprise in accordance with his capital contribution.

7. ". . . Its [the trust property's] use was to be without restriction by the donee-trust—because the donee-trust was only a special or limited partner. . . ." (Brief, 17-18). This statement merely recasts the statements numbered 2 and 4, *supra,* and is no more in accord with the facts or the law than are those statements.

8. ". . . Its [the trust property's] continued availability was assured because the donee-trust was not free to withdraw or transfer its interest. . . ." (Brief,

18). This statement is a mere repetition of the statement numbered 3, *supra.*

9. " . . . Determinations of the Taxpayer, as general partner, were binding upon the partnership and he established the policy of the partnership. . . ." (Brief, 18). This statement, too, is not without its misleading aspects, for only some, but not all, of the Taxpayer's determinations were binding on the partnership. Thus, as has been pointed out above, the determination as to Taxpayer's salary and as to the time and amount of withdrawal of earnings was to be made jointly by the Taxpayer and the special partner. Moreover, as has been repeatedly reiterated, any determination by the Taxpayer, as the general partner, could lawfully be made only in absolute good faith and in the interests and for the benefit of the partnership. No such determination could lawfully be made by the Taxpayer for his own personal benefit. It is far from uncommon for partnerships, general, special or limited, to utilize managing partners, and the practice has been given express recognition by the courts. *J. A. Riggs Tractor Co.,* 6 TC 889 (1946); *George Brothers & Co.,* 41 BTA 287 (1940).

Clearly, the powers held by the Taxpayer under the trust deed and partnership agreement—and he held very few, if any, of those attributed to him by the Commissioner—do not singly or in the aggregate constitute the "bundle of rights" requisite for the invocation of the doctrine of *Helvering v. Clifford.*

The Commissioner, in his reliance on *Toor v. Westover, supra,* seeks to narrow the holding of this court to a degree unwarranted by the facts and the opinion therein.

That case originated as an action in the District Court for the Southern District of California against a collector of internal revenue to recover sums paid as a result of deficiency assessments of income tax. The case was tried, argued and submitted, and the District Court made and entered its findings of fact. These findings revealed the following situation: Plaintiff made trust agreements with a bank for the benefit of his children, and the trustee of the trusts so created executed articles of limited partnership with plaintiff as the general partner. Under the trust agreements the trustee was restricted to investments either in businesses in which plaintiff was a partner or principal shareholder, or in government bonds. The trust agreements were revocable by the plaintiff as grantor. Plaintiff retained exclusive dominion of the property, the disposition and allocation of the funds derived from the partnership business and all matters requiring judgment or management.

In no instance did the bank use its independent judgment on partnership matters nor did it exercise any of the rights of partnership even by way of advice. The bank, as limited partner, did not exercise dominion and control over the trust corpus in the business nor did it influence the conduct of the partnership or the disposition of the income thereof. The partnership articles conferred on the plaintiff the absolute right to purchase the interest of the limited partner at its book value. There was no business purpose underlying the creation of the partnership, and the District Court commented that the conclusion was warranted that its sole object was to diminish tax liability.

The District Court, applying the *Tower,*[5] *Lusthaus,*[6] and *Culbertson,*[7] rules found as a matter of fact that the plaintiff and the trustee-bank did not in good faith intend to join together in the present conduct of the business enterprise (94 F. Supp. 860, 864-66) and entered judgment for defendant.

On appeal to this court, the judgment of the District Court was affirmed in an opinion by Circuit Judge Orr. This court held that the donee trust did not become the substantial owner of a partnership interest which would entitle the partnership to recognition for tax purposes. In reaching that conclusion this court stated that considering the fact that the donee was neither free to remain out of the partnership nor free to terminate or transfer its interest once the partnership was created, and that the plaintiff, as general manager, retained the powers of management and full discretion as to time and amounts of distribution of profits, the plaintiff re-

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[5]*Commissioner of Int. Rev. v. Tower,* 327 U.S. 280, 90 L.ed 670 (1946).

[6]*Lusthaus v. Commissioner of Int. Rev.,* 327 U.S. 293, 90 L.ed 679 (1946).

[7]*Commissioner v. Culbertson, supra.*

mained the substantial owner of the interest he purported to have given away.

In its statement of the case this court recounted substantially all of the facts hereinabove referred to. It quoted the reports of the Senate and House Committees on the Revenue Bill of 1951[8] and in particular the statement that:

> "Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the lights [sic] of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit."

saying of this statement:

> "We believe that this has always been the law". (200 F.2d 713, 716.)

Thus, it appears that in arriving at its decision in *Toor v. Westover, supra,* this court, while pointing out for the guidance of the lower court the significance of the fact that the donee-trust was neither free to remain out of the partnership nor to terminate or transfer its interest once the partnership was created, did not intend to rule that those facts alone and without regard to the other factors present—the revo-

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[8]Sen. Rep. No. 781, 82d Cong. 1st Sess. (1951); H.R. Rep. No. 586, 82d Cong. 1st Sess. (1951).

cability of the trust, the plaintiff's exclusive domination of the property and disposition of the funds derived from the partnership, the special partner's completely passive role, and the plaintiff's absolute right to buy out the limited partner at book value—among others—were sufficient in themselves to establish retained substantial ownership in the purported donor.

To adopt the reading of *Toor v. Westover, supra,* contended for by the Commissioner, is to impute to this Court a departure from the doctrine of both the *Culbertson* and the *Clifford* cases. The Supreme Court, in the *Culbertson* case, stressed the importance of considering all of the facts in any family partnership case, rather than attempting to apply one or two "objective" tests. And in the *Clifford* case, that Court emphasized the cumulative effect of the entire bundle of rights retained by the purported donor, and held that they amounted in the aggregate to substantial ownership.

The Commissioner, however, urges that the holding of this Court in the *Toor* case sets up two objective tests in family partnership cases, namely, that in order to be a bona fide partner, recognizable for income tax purposes, a partner must be (1) free to remain out of the partnership and (2) absolutely free to terminate or transfer his interest once the partnership is created. Not only does this reading of the *Toor* case depart from the rationale of the *Culbertson* and *Clifford* cases, but it also tends to bring this court into unnecessary conflict with the Courts of Appeals for the Eighth and Tenth Circuits. *Thompson v. Riggs*, 175 F. 2d 81 (8th Cir. 1949); *Nicholas v. Davis*, 204 F. 2d 200 (10th Cir. 1953).

Thompson v. Riggs, supra, was an appeal from a judgment for the plaintiff in an action for refund of income taxes. The plaintiff was the owner of a 60% interest in a partnership in which the remaining 40% interest belonged to his son. Plaintiff transferred out of his 60% interest 5% each to six irrevocable trusts for the benefit of plaintiff's wife and plaintiff's son's family. Plaintiff, his son and a bank were named trustees of each of the trusts. Plaintiff, his son and the trustees then entered into a new partnership agreement.

The trust instruments provided in relevant part that on all matters concerning the management and control of the partnership business, authority to speak for the trustees was vested in plaintiff and his son to the exclusion of the bank, and that the bank was to act as a naked trustee exercising no discretion and being charged with no liability or responsibility for or arising out of the conduct of the partnership business. The trustees could withdraw from the partnership but any decision as to whether to do so was to be made solely by the plaintiff and his son to the exclusion of the bank. Similarly, the trustees could acquire additional interests in the partnership, but the right to determine whether to do so was vested solely in the plaintiff and his son. The partnership agreement provided that the management of the partnership business was vested in the plaintiff and his son (and plaintiff's grandson when and if he attained maturity and so long as he retained an interest in the business either as trustee or individually), and further provided that in the event of any disagreement as to the management of the partnership business, the decision of the plaintiff would control so long as he retained an interest in the business individually or as trustee. No partner could assign his interest (except to another partner) without the consent of all of the partners. The trust for the benefit of plaintiff's grandson had an option to purchase the interest of any of the other trusts at net book value.

Since the transfer was of an interest in the partnership and since the right to determine whether any trust should withdraw from the partnership was retained by the plaintiff and his son, the trusts were not free to remain out of the partnership. Since no partner could transfer his interest without the consent of all of the partners (including the plaintiff), none of the trusts was absolutely free to transfer its interest once the partnership was created. Nevertheless, the Court of Appeals, reviewing all of the facts and with the case of *Helvering v. Clifford* having been called to its attention, affirmed the judgment for the plaintiff.

Nicholas v. Davis, supra, concerned three successive partnerships, the second of which was a limited partnership. In the second partnership the limited partners were the wives of the general partners. Each general partner gave his wife certain sums of money from the capital assets of the preceding partnership with the understanding among all of them that the gifts were to be used for the purchase of limited partners' interests in the second partnership. It appears that the limited partners could neither withdraw nor transfer their interests since the limited partnership agreement provided that it was to continue for a stated term and that the limited partners would be entitled to the return of their contributions upon the expiration of the term of the partnership, upon the dissolution of the partner or upon the consent of all of the other members of the partnership, both general and limited.

The Commissioner assessed a deficiency in income tax against one of the general partners on the theory that the income of his wife as a limited partner was in reality income of that general partner. The general partner concerned brought an action against a collector to recover the amount of the deficiency assessment paid, and the cause was tried before a jury. The plaintiff offered evidence showing, among other things, the facts set out above and the fact that the limited partner enjoyed complete dominion over her distributive share of partnership income, and the collector offered no evidence whatever. By direction of the trial court, a verdict was returned in favor of the plaintiff taxpayer. On appeal from a judgment entered thereon, the Court of Appeals for the Tenth

Circuit affirmed the judgment, holding that no question of credibility or issue of fact was presented for determination by a jury.

In each of the foregoing cases the challenged partner was not absolutely free to remain out of the partnership or to terminate or tranfer his interest once the partnership was created. On all of the facts in the record, however, those courts held the partnerships concerned to be bona fide recognizable partnerships for income tax purposes.

Given a case in which an examination of all of the evidence leaves doubt as to whether in fact and in law the donor of property has retained such control and dominion thereof as to render him liable for taxes on the income thereof under the doctrine of the *Clifford* case, the addition of the two factors mentioned could properly be sufficient to turn the decision in favor of taxability. It is respectfully submitted that such was the case in *Toor v. Westover, supra,* and that this court, in arriving at its decision in that case, did not base its determination solely upon those two factors, but rather, considering all of the circumstances, found a lack of true ownership in the transferee of the trust property. This rationale is not only borne out by this court's opinion, but also avoids the creation of a conflict of decision between this and the Eighth and Tenth Circuits.

CONCLUSION.

For the reasons set forth, the decisions of the Tax Court are correct and should be affirmed.

Dated, Honolulu, Hawaii,
November 2, 1953.

Respectfully submitted,
MILTON CADES,
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SMITH, WILD, BEEBE & CADES,
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(Appendix Follows.)

Appendix.

Appendix

Internal Revenue Code:

Sec. 22. Gross Income

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

Sec. 182. Tax of Partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him——

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 1946 ed., Sec. 182.)

Revised Laws of Hawaii (1935):

Chapter 225. Partnerships, Registration of.

*   *   *   *   *   *   *

Part 2. Special

Sec. 6870. *Between individuals.*—A partnership may be formed between two or more individuals for the transaction of any lawful business. A special partnership may be formed between one or more persons, called general partners, and one or more persons called special partners, for the transaction of any business.

*   *   *   *   *   *   *

Sec. 6880. *Only general partners act.*—The general partners only shall have authority to transact the business of a special partnership.

Sec. 6881. *Special partners may advise.*—A special partner may at all times investigate the partnership affairs and advise his partners or their agents as to their management.

Sec. 6882. *May loan money. Insolvency.*—A special partner may lend money to the partnership or advance money for it, or to it, and take from it security therefor, and as to such secured loans or advances has the same rights as any other creditor, but in case of the insolvency of the partnership all other claim which he may have against it must be postponed until all other creditors are satisfied.

Sec. 6883. *Receive interest and profits.*—A special partner may receive such lawful interest and such proportion of profits as may be agreed upon, if not paid out of the capital invested in the partnership by him or some other special partner, and is not bound to refund the same to meet subsequent losses.

Sec. 6884. *May not withdraw capital.*—No special partner, under any pretense, may withdraw any part of the capital invested by him in the partnership during its continuance.

Sec. 6885. *Result of withdrawing capital.*—If a special partner withdraws capital from the firm, contrary to the provisions of sections 6883 or 6884, he thereby becomes a general partner.

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LIABILITY OF PARTNERS.

* * * * * * *

Sec. 6887. *Of special partners.*—The contribution of a special partner to the capital of the firm, and the increase thereof, is liable for its debts; but he is not otherwise liable therefor, except as follows:

1. If he has wilfully made or permitted a false or materially defective statement in the certificate of the partnership, the affidavit filed therewith, or the published announcement thereof, he is liable as a general partner to all creditors of the firm; or,

2. If he has wilfully interfered with the business of the firm, except as permitted hereinabove, he is liable in like manner; or,

3. If he has wilfully joined in or assented to an act contrary to any of the provisions of sections 6880-6885, he is liable in like manner.

Sec. 6888. *For unintentional act.*—When a special partner has, unintentionally, done any of the acts mentioned in the last section, he is liable, as a general partner, to any creditor of the firm who has been actually misled thereby to his prejudice.